

CALIFORNIA FRANCHISE TAX BOARD

Legal Ruling No. 354

February 6, 1973

TAX PREFERENCE INCOME: EXCLUSION TO BE ALLOWED A TRUST AND BENEFICIARY

Syllabus:

Section 17062 of the Revenue and Taxation Code provides:

In addition to the other taxes imposed by this part, there is hereby imposed for each taxable year, with respect to the income of every taxpayer under this part, a tax equal to 2.5 percent of the amount (if any) by which the sum of the items of tax preference in excess of thirty thousand dollars (\$30,000) is greater than the amount of net business loss for the taxable year.

Advice has been requested as to how the \$30,000 exclusion is to be allowed in the following situations:

1. A trust has \$40,000 in tax preference income. It distributes \$20,000 of the tax preference income to a single beneficiary. The beneficiary has no other tax preference income.

Questions: What exclusion is allowable on the Form 540?

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2. A trust has \$40,000 in tax preference income. It distributes \$20,000 of the tax preference income to a single beneficiary. The beneficiary has \$5,000 in tax preference income generated by his own assets.

Question: What exclusion is allowable on the Form 540?

3. In 1972, a complex trust has gross income of \$150,000, which includes \$100,000 in gain from assets held for more than five years.

The trust instrument provides that income is to be distributed currently but that capital gains shall be allocated to corpus and accumulated until the fifteenth anniversary of the trust, at which time the trust will terminate and all assets will be distributed to the beneficiary.

The only item of tax preference is the \$50,000 difference between the total gain of \$100,000 and the \$50,000 recognized under Section 18162.5.

The trust distributed \$50,000 to the beneficiary and paid tax on the \$50,000 of recognized capital gain.

- Questions:
- a. What portion of the items of tax preference will be allocated to the trust?
 - b. What exclusion is allowable on the Form 541?
 - c. If a portion of the items of tax preference are allocable, i.e. required to be currently distributed, to the beneficiary, when will the preference tax be applied?
 - (1) In the year the capital gain is realized?
 - (2) In the year the trust distributes the accumulated capital gain?

The answers to the above questions are set forth below.

1. Section 17064.5 (b) states:

(b) In the case of an estate or trust --

(1) The sum of the items of tax preference for any taxable year of the estate or trust shall be apportioned between the estate or trust and the beneficiaries on the basis of the income of the estate or trust allocable to each, and

(2) The thirty thousand dollars (\$30,000) amount specified in Section 17062 applicable to such estate or trust shall be reduced to an amount which bears the same ratio to thirty thousand dollars (\$30,000) as the portion of the sum of the items of tax preference allocated to the estate or trust under paragraph (1) bears to such sum.

Under the above section it is noted that the trusts' \$30,000 exclusion is subject to reduction by reason of a distribution to a beneficiary, but no similar reduction is made to the beneficiary's exclusion upon receipt of a distribution from the trust.

Section 17062, subject to the modifications set forth in Section 17064.5, allows every taxpayer a \$30,000 exclusion. Therefore, since the beneficiary received \$20,000 of tax preference income from the trust, the entire \$20,000 is excludable from the Form 540. The \$30,000 exclusion, of course, is only allowable to the extent of tax preference income.

Under the facts given, the trust's \$30,000 exclusion must be reduced by 50% -- the proportion of the tax preference income allocated to it.

Computation is as follows:

$\$20,000 / \$40,000 \times \$30,000 = \$15,000$ allowable exclusion on Form 541

2. Where an item of tax preference of a conduit entity is apportioned to a distributee, the item of tax preference retains its character in the hands of the distributee and is adjusted to reflect: (1) the separate items of income and deduction of the distributee and (2) the tax status of the distributee as an individual, corporation, etc. (Proposed Federal Regulations 1.58-2(a)). The exclusion allowable on the Form 540 is therefore:

Beneficiary's tax preference income	\$ 5,000
Trust's tax preference income distributed	<u>20,000</u>
Exclusion Allowable	<u>\$25,000</u>

3. (a) Proposed Federal Regulation 1.58-3(a)(1) provides:

Section 58 (c)(1) provides that the sum of the items of tax preference of an estate or trust shall be apportioned between the estate or trust and the beneficiary on the basis of the income of the estate or trust allocable to each. Income for this purpose is the income received or accrued by the trust or estate which is not subject to current taxation either in the hands of the trust or estate or the beneficiary by reason of an item of tax preference. The character of the amounts distributed is determined under section 652(b) or 662(b) and the regulations thereunder. (Emphasis added)

Since, under the above regulation the only "income" to be considered in the instant question for the purpose of apportioning tax preference items between the trust and the beneficiary is the \$50,000 capital gain, deduction which was not allocable to the beneficiary, all the tax preference income will be allocated to the trust.

(b) The trust, having been allocated the entire \$50,000 tax preference income, may claim a \$30,000 exclusion.

(c) Proposed Federal Regulation 1.58-3(a) (4) states that items of tax preference apportioned to the beneficiary are to be taken into account by the beneficiary in the same taxable year in which the income on which such apportionment is based is received or accrued by the beneficiary.

Accordingly, the preference tax will be applied in the year the tax preference income is distributed or distributable to the beneficiary.

It should be noted that the conclusions reached in this memorandum are based in part on proposed federal regulations and, therefore, may be subject to change in the future.